[COMMITTEE PRINT]

# PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND KOREA

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PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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## INTRODUCTION

This pamphlet describes the proposed income tax treaty between the United States and the Republic of Korea. The pamphlet covers the treaty as signed by both governments on June 4, 1976, together with related notes exchanged on the same date. The proposed treaty has been submitted to the Senate for advice and consent to its ratification.

There is presently no income tax treaty in force between the United States and Korea. The proposed treaty is intended to reduce or eliminate double taxation of income earned in one country by residents of the other country, to assist in collection and other administrative matters between the United States and Korea, and to promote closer economic cooperation and more active trade between the two countries.

The proposed treaty is substantially similar to other recent United States income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). The more significant features of the proposed treaty are summarized below:

(1) The proposed treaty, as in the case of other income tax treaties, establishes maximum rates for the U.S. and Korean withholding taxes on passive income payments flowing between the two countries. Under article 12, the rate of withholding tax on portfolio dividends is limited to 15 percent while the rate of tax may not exceed 10 percent on dividends paid by a subsidiary in one country to a parent corporation in the other. Under article 13, the maximum rate of withholding tax on interest is 12 percent except that interest derived by the government of either country, or by its local authorities or instrumentalities, is exempt from withholding at the source. Royalties are subject in general to a 15-percent maximum rate of withholding tax (article 14). However, the tax on literary and artistic royalties, including motion picture royalties, is limited to 10 percent.

(3) The provisions of the proposed treaty dealing with the taxation of business (article 8 and 9) and personal service income (articles 18 through 24) are essentially the same as in other recent U.S. tax treaties, as are the provisions dealing with definitional and administrative matters. For example, a resident of one country will not be subject to tax in the other country on business profits unless those profits are attributable to a permanent establishment which the resident maintains in the other country. Similarly, for business visitors from one country temporarily present in the other, the host country may tax the visitors only if certain tests (based on time spent or amounts earned) are met.

(3) The proposed treaty contains a special provision (article 25), not found in other income tax treaties, which provides a special exemption from U.S. social security taxes for Korean residents who are working on a temporary basis in Guam. A similar exemption is provided in the Internal Revenue Code for Philippine residents temporarily present in Guam. The provision was included to prevent the Philippine exemption from providing an advantage to Philippine residents in seeking temporary employment in Guam. The proposed treaty provides that Korean residents will be exempt from social security taxes only so long as the statutory exemption is in effect for Philippine residents.

(4) The proposed treaty provides (article 10) that income derived by U.S. residents from the operation of ships or aircraft in international traffic is exempt from Korean tax and that such income derived by Korean residents is exempt from U.S. tax. This exemption is broader than the exemption which has customarily been provided in U.S. tax treaties, under which shipping and air transport income of a resident of one country is exempt by the other only if the ships or aircraft are registered in that country.

(5) Finally, in the related exchange of notes, the United States agrees, when feasible, to resume discussions with Korea with a view toward reaching agreement on a supplementary protocol which would minimize the interference of the U.S. tax system with special incentives provided by Korea to promote the flow of United States capital and technology to Korea. The exchange of notes is similar in effect to the notes exchanged in connection with the U.S. income tax treaty with Trinidad and Tobago.

## General Explanation

*Article 1. Taxes covered*

The proposed treaty applies to the U.S. Federal income taxes imposed under the Internal Revenue Code. In the case of Korea, it applies to the income tax and the corporation tax imposed by that country. Pursuant to an exchange of notes accompanying the signing of the proposed treaty, the proposed treaty also applies to the Korean Defense Tax to the extent that it is assessed with respect to the Korean income and corporation taxes.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose.

Additionally, it is provided that the nondiscrimination provisions (Article 7) of the treaty apply to all taxes of every kind imposed at the national, State, or local level by the United States or Korea. The exchange of information provisions (Article 28) of the proposed treaty will also apply to all taxes of every kind imposed by the two countries at the national level.

*Article 2. General definitions*

The standard definitions found in most of our income tax treaties are contained in the proposed treaty.

Under the proposed treaty, the term "United States" when used in a geographical sense means the States of the United States and the District of Columbia. Thus, the treaty does not apply to possessions of the United States or to the Commonwealth of Puerto Rico. The term "Korea" when used in a geographical sense means all territory in which the Korean tax laws are in force. The terms "United States" and "Korea" also include their respective territorial seas and, in general accord with the principles of section 638 of the Code, their continental shelves.

For purposes of the proposed treaty, a U.S. corporation is defined as a corporation created or organized under the laws of the United States, any State thereof, or the District of Columbia, or any unincorporated entity treated as a U.S. corporation for U.S. tax purposes. A Korean corporation is defined as a corporation (other than a U.S. corporation) which has its head office in Korea, or any other entity treated as a Korean corporation for Korean tax purposes.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty. Where a term is defined in a different manner by the two countries or where its meaning under the laws of either country is not readily determinable, the competent authorities of the two countries may establish a common meaning for the term in order to prevent double taxation or to further any other purpose of the treaty.

*Article 3. Fiscal domicile*

The benefits of the proposed treaty generally are available only to residents of the two countries. The proposed treaty defines "resident of Korea" and "resident of the Unted States," and in addition provides a set of rules to determine residence in the case of an individual with dual residence. This provision of the proposed treaty is based on the fiscal domicile article of the OECD model tax treaty and is similar to the provisions found in other U.S. tax treaties.

For purposes of the proposed treaty, a resident of Korea is a Korean corporation and any person other than a corporation who is treated as a resident of Korea for purposes of its tax. Similarly, for purposes of the proposed treaty, a resident of the United States is a U.S. corporation or any person other than a corporation treated as a U.S. resident for U.S. tax purposes. Thus, for purposes of the treaty, a U.S. resident would include a resident alien individual as well as a resident citizen, but in no event would it include any foreign corporation. Also, citizens of the United States and Korea are not automatically United States or Korean residents under the proposed treaty.

An individual whom both countries consider to be a resident according to their general rules for determining residence will be deemed for all purposes of the treaty to be a resident of the country in which he has his permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement.

*Article 4. General rules of taxation*

The proposed treaty contains the basic general rules of taxation which are found in most of our other tax treaties. A resident of one country may be taxed by the other country only on income from sources within that other country (which includes business profits only to the extent they are attributable to a permanent establishment in that other country). For this purpose, the source rules of Article 6 are to be applied. The proposed treaty also contains the customary rule that it may not be applied to increase the tax burden imposed on residents of either country beyond what it would be in the absence of the treaty—that is, the treaty only applies in those situations where it benefits taxpayers.

Additionally, the usual savings clause is contained in the proposed treaty. Under this clause, it is provided that, with certain exceptions, the proposed treaty is not to affect the taxation by the United States or Korea of their citizens or residents. However, the savings clause does not apply in several cases where its application would nullify specific policies contained in the proposed treaty which are designed to benefit residents and citizens. The principal exceptions involve the benefits provided to citizens and residents with respect to social security payments, the foreign tax credit, and nondiscrimination. The savings clause also does not affect the benefits provided to resident aliens under the provisions relating to governmental employees, teachers, and students, provided they do not have immigrant status in the country imposing the tax.

Similar to certain other U.S. tax treaties, the proposed treaty limits to some degree the right of the United States to impose its personal holding company tax and accumulated earnings tax with respect to corporations. Under the proposed treaty, a Korean corporation will be exempt from the personal holding company tax if at all times during the taxable year all of its stock is owned by Korean residents (who are not U.S. citizens). In addition, a Korean corporation will be exempt from the accumulated earnings tax in any taxable year unless it is engaged in trade or business in the United States through a permanent establishment at any time during such year. In the event a Korean corporation does not satisfy the requirements for exemption under the proposed treaty, it may be subjected to the accumulated earnings tax only with respect to income from sources within the United States (Treas. Reg. § 1.532–1(c)).

The proposed treaty also has two special rules which are not found in other U.S. tax treaties. First, the proposed treaty is not to affect Korean law so as to deny benefits accorded U.S. residents under the Korean Foreign Capital Inducement Law or any similar law to encourage investment in Korea. This provision applies only with respect to Korean law and has no impact on U.S. tax on the Korean source income which may benefit from such provisions.

Second, the proposed treaty provides that for U.S. tax purposes residents of Korea will be allowed a deduction for personal exemptions (subject to the conditions of Code secs. 151 through 154 as in effect on June 4, 1976) for the spouse of the Korean resident and for each child of the Korean resident present in the United States and residing with him in the United States at any time during the taxable year. These additional deductions shall not exceed the Korean resident's income from sources within the United States which is effectively connected with the conduct of a U.S. trade or business. The additional deductions are continued as long as the Internal Revenue Code provides only one personal exemption for nonresident aliens.

*Article 5. Relief from double taxation*

Under the proposed treaty, each country agrees to provide its citizens and residents with a foreign tax credit for the appropriate amount of income taxes paid to the other country. The credit allowed for U.S. tax purposes is in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question. The credit allowed by Korea is limited to the amount of Korean tax attributable to income from sources within the United States.

The proposed treaty also provides that a deemed-paid foreign tax credit will be made available to a U.S. corporation with respect to dividends from a Korean corporation in which it has at least a 10-percent ownership interest. In this case, a credit will be allowed for the Korean tax paid by the Korean corporation on the earnings out of which the dividend is paid. A deemed-paid foreign tax credit satisfying the treaty requirements is presently provided under the Internal Revenue Code. Similarly, the proposed treaty provides that Korea is to provide a deemed-paid foreign tax credit for U.S. tax attributable to dividends received by Korean corporations from U.S. corporations in which they are 10-percent shareholders.

For the purpose of applying the U.S. foreign tax credit in relation to taxes paid to Korea, the rules set forth under Article 6 will be applied to determine the source of income. The Korean taxes which the proposed treaty provides are creditable for U.S. tax purposes are the Korean income tax, corporation tax, and Defense tax (to the extent it is imposed as a surtax on the income and corporation taxes). These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty.

*Article 6. Source of income*

The source of income rules are important in view of the general rule in the treaty (Article 4) that one country may tax residents and corporations of the other country only on income from sources within the taxing country (provided, with certain exceptions, that the resident is not a citizen of the taxing country). They are also important because the limitation on the foreign tax credit is based on the source of income. Several of the source rules contained in the proposed treaty differ in some degree from the source rules provided in the Internal Revenue Code. Since the general rules of taxation contained in the proposed treaty (Article 4) provide that it will not be applied increase a person's tax, a taxpayer is not bound to apply the rules described below in calculating his U.S. tax liability.

The proposed treaty provides that dividends will be treated as income from sources within a country only if paid by a corporation of that country.

Under the proposed treaty, interest will be treated as income from sources within a country only if paid by that country, a political subdivision or a local authority thereof, or by a resident of that country. However, interest paid by a permanent establishment (on an indebtedness incurred in connection with the permanent establishment) will be sourced in the country where the permanent establishment is situated. This exception permits one country, under the proper circumstances, to tax interest paid by a permanent establishment maintained in that country by a resident of the other country or by a resident of a third country. For example, if a resident of France has a permanent establishment in Korea which borrows money from a resident of the United States, the interest paid by the Korean permanent establishment will be deemed to be from Korean sources and Korea may therefore tax the interest payments. The United States would not under the Internal Revenue Code (sec. 861) impose its withholding tax on interest paid to nonresident alien individuals or foreign corporations by a foreign corporation having a permanent establishment in the United States unless the majority of the foreign corporation's gross income from all sources for the 3-year period preceding the payment of the interest was effectively connected with the conduct of a U.S. trade or business.

In addition, the source rule for interest paid by permanent establishments will operate to exempt interest from tax in the country of the payor's residence if the interest is paid to a resident of the other country by a permanent establishment situated in a third country (and the indebtedness was incurred in connection with the third country permanent establishment). This results from the restriction in Article 6 (General rules of taxation) that a resident of one country who is not a citizen of the other country may be taxed by the other country only on income from sources within that other country.

The proposed treaty provides that royalties for the use of, or the right to use, property (other than ships and aircraft) will be treated as income from sources within a country only to the extent that such royalties are for the use of, or the right to use, the property within that country.

Income and gains from real property (including mineral royalties) will be treated as income from sources within a country only if the real property (including, in the case of a mineral royalty, the underlying real property) is situated in that country.

Income from the rental of tangible personal (movable) property will be treated as income from sources within a country only to the extent that the property is located in that country. Income from the rental of ships or aircraft derived by a person not engaged in the operation of ships or aircraft in international traffic shall be treated as income from sources within a country only if the lessee is a resident of that country.

Income from the purchase and sale of intangible or tangible personal property (other than contingent gains described in paragraph (4) (b) of Article 14 (Royalties)) will be treated as income from sources within a country only if sold within that country.

Income received with respect to the performance of labor or personal services by an individual, whether as an employee or in an independent capacity, will be treated as income from sources within a country only to the extent that such services are performed in that country. Income from personal services performed aboard ships or aircraft operated by a resident of one country in international traffic will be treated as income from sources within that country if performed by a member of the regular complement of the ship or aircraft. For purposes of the source rules, income from personal services includes pensions (as described in Article 23(3)). However, compensation described in Article 22 (Governmental functions) and social security payments (Article 24) will be treated as income from sources within the country making the payments.

Industrial or commercial profits attributable to a permanent establishment will be considered to be from sources within the country in which the permanent establishment is located. This rule also applies to passive income of the types described above in situations where the passive income is treated as industrial or commercial profits because it is effectively connected with the permanent establishment.

The source of any item of income not specified in this Article will be determined by each country in accordance with its own law. However, if the source of any item of income under the laws of one country is different from its source under the laws of the other country, or if its source is not readily determinable under the laws of either, the competent authorities of the two countries may, in order to prevent double taxation or further any other purpose of the proposed treaty, establish a common source of the item of income for purposes of the proposed treaty.

*Article 7. Nondiscrimination*

The proposed treaty contains a comprehensive nondiscrimination provision relating to all taxes of every kind imposed at the national, State, or local level. It is similar to provisions which have been embodied in other recent U.S. income tax treaties. Neither country

can discriminate by imposing more burdensome taxes on its residents who are citizens of the other country, or on permanent establishment of residents of the other country, than it imposes on comparable taxpayers. The nondiscrimination provision also applies to corporations of one country which are owned by residents of the other country. This provision does not, however, require either country to grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of personal status or family responsibilities which it grants to its own residents.

*Article 8. Business profits*

Under the proposed treaty, industrial and commercial profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the resident actively conducts a trade or business.

In computing the taxable industrial and commercial profits, the deduction of all expenses, wherever incurred, which are reasonably connected with the business profits are allowed. Deductible expenses include executive and general administrative expenses. However, in determining the amount of the deduction for head office expenses, the deduction may be limited to the expenses actually incurred by the head office without including a profit element.

The profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to it the industrial or commercial profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment.

Industrial and commercial profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment (or by the resident of which it is a permanent establishment) for the account of that resident. Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities.

For purposes of the proposed treaty, the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, financing, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal property (including ships and aircraft). The term does not include income from the rental or licensing of motion picture films, films or tapes used for radio or television broadcasting, or income from the performance of personal services derived by an individual either as an employee or in an independent capacity. The proposed treaty follows the approach of our other recent tax treaties and the Internal Revenue Code by including within "industrial and commercial profits" investment income (income from dividends, interest, certain royalties, capital gains, and income derived from real property and natural resources) where the income is effectively connected with a permanent establishment. Such effectively

connected passive income is included whether or not it is derived from an industrial or commercial activity.

The proposed treaty also contains criteria for determining whether income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to the income are used in (or held for use in) carrying on an industrial or commercial activity through a permanent establishment and whether the activities carried on through the permanent establishment are a material factor in the realization of the income. For this purpose, due regard will be given to whether or not the property or rights or the income is accounted for through the permanent establishment. The effectively connected concept in this paragraph is substantially similar to the effectively connected concept in the Code (see. 864(c)).

*Article 9. Definition of permanent establishment*

The proposed treaty contains a definition of permanent establishment which follows the pattern of other recent U.S. income tax treaties and the OECD model tax treaty. The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties are applicable.

In general, a fixed place of business through which a resident of one country engages in industrial or commercial activities in the other country is considered a permanent establishment. This includes a branch; an office; a factory; a workshop; a warehouse; a store or other sales outlet; a mine or quarry or other place of extraction of other natural resources; or any building site, construction or construction project which lasts for more than 6 months.

This general rule is modified to provide that a fixed place of business which is only used for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident for purposes of storage, display, delivery, or processing by another person; and the purchase of goods, collection or supply of information, advertising, scientific research, or other auxiliary activities for the resident. A resident shall not be deemed to have a permanent establishment in the other country merely because the resident sells goods which were displayed at trade fairs or conventions in that other country. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

A resident of one country will be deemed to have a permanent establishment in the other country if the resident (1) has a fixed place of business in that country and (2) sells for use or consumption in that country goods or merchandise which were subjected to substantial processing in that country (whether or not purchased there) or were purchased in that country and not subjected to substantial processing outside that country.

A resident of one country will be deemed to have a permanent establishment in the other country if it maintains an agent in the other country who has, and regularly exercises, a general contracting authority (other than for the purchase of merchandise) in that other country. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent or other agent of independent status acting in the ordinary course of its business.

The determination of whether a resident of one country has a permanent establishment in the other country is to be made without regard to the fact that the resident may be related to a resident of the other country or to a person who engages in business in that other country.

*Article 10. Shipping and air transport*

The proposed treaty provides that income which is derived by a resident of either country from the operation of ships and aircraft in international traffic shall be exempt from tax by the other country. The exemption provided in the proposed treaty is broader than the exemption customarily provided in U.S. tax treaties under which shipping and air transport income of a resident of one country is exempt by the other only if the ships or aircraft are registered in the first country.

Income from the operation in international traffic of ships or aircraft includes income derived from the use or lease of containers, trailers for the inland transportation of containers, and other related equipment where such income is incidental to the actual operation of ships or aircraft in international traffic. It does not, however, include other income from the inland transportation of containers.

*Article 11. Related persons*

The proposed treaty, like most other U.S. tax treaties, contains a provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

It is anticipated that when a redetermination has been made by one country with respect to the income of a related person, the other country will attempt to reach an agreement with the first country in connection with the redetermination and, if it agrees with the redetermination, it will make a corresponding adjusting to the income of the other person.

For purposes of the proposed treaty, a person is related to another person if either person directly or indirectly owns or controls the other, or if a third person (or persons) directly or indirectly owns or controls both. Control includes any kind of control, whether or not legally enforceable, and however exercised or excercisable.

*Article 12. Dividends*

The proposed treaty generally limits the rate of withholding tax in the source country on dividends derived by a resident of the other country to 15 percent generally. The withholding tax rate is limited to 12.5 percent in the case of dividends paid to a corporation which

owns at least a 10-percent of the voting stock of the distributing corporation (provided not more than 25 percent of the income of the paying corporation consists of dividends and interest on portfolio investments—i.e., the company is not essentially an investment company).

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment in the source country and the dividends are effectively connected with the permanent establishment. If the dividends are effectively connected with a permanent establishment, the dividends are to be taxed under the business profits provisions (Article 8). This treatment of dividends generally conforms to that provided by the Internal Revenue Code, other recent U.S. income tax treaties, and the OECD model tax treaty.

*Article 13. Interest*

The proposed treaty generally limits any withholding tax on interest derived by a resident of one country from sources within the other country to 12 percent of the gross amount of interest paid.

The reduced rates of withholding tax on interest will apply unless the recipient has a permanent establishment in the source country and the interest is effectively connected with the permanent establishment. If the interest is effectively connected with a permanent establishment then it will be taxed under the business profits provisions (Article 8) of the proposed treaty. This treatment generally conforms to that provided by other recent U.S. tax treaties and the OECD model tax treaty.

The proposed treaty also provides that interest derived beneficially by either country, by any locality of either country, or by a central bank of either country, will be exempt from tax by the other country. Under this rule income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Korean residents will be exempt from tax by Korea.

The proposed treaty defines interest as income from bonds, debentures, government securities, notes, or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits and debt claims of every kind. Interest also includes all other income which under the tax laws of the source country is assimilated into income from money lent. In situations where the payor and recipient are related, the interest provision of the proposed treaty only applies to the arm's-length amounts of interest which would have been paid had they not been related.

*Article 14. Royalties*

Under the proposed treaty, the withholding tax on royalties derived by a resident of one country from sources within the other is limited to 10 percent in the case of a copyright or film royalty, and 15 percent in the case of other royalties. However, this article does not apply to mineral royalties (which are covered by Article 15).

The 10-percent withholding rate provided for copyright or film royalties applies to royalties derived from copyrights, or rights to use, produce, or reproduce any literary, dramatic, musical, or artistic works, including motion picture films or films or tapes used for radio

or television broadcasting. The 15-percent withholding rate applies to payments of any kind made as consideration for the use of, or the right to use, scientific works, patents, designs, models, plans, secret processes or formulas, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how). Royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts received are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not contingent, the provisions of Article 16 (Capital gains) may apply. Royalties also include payments for the use of ships or aircraft, but only if the lessor is not engaged in the operation of ships or aircraft in international traffic.

The reduced withholding rates do not apply where the recipient has a permanent establishment in the source country and the royalties are effectively connected with a permanent establishment; in that event the royalties will be taxed under the business profits provisions (Article 8).

As in the case of the interest provision, the royalty provision does not apply to that part of a royalty paid to a related person which exceeds an arm's-length rate.

*Article 15. Income from real property*

The proposed treaty provides that income from real property may be taxed in the country where the real property or natural resources are located. Income from real property includes income from the direct use or renting of the property and gains on the sale, exchange, or other disposition of the property. It also includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains on the sale, exchange or other disposition of the royalty rights or the underlying natural resource. Income from real property does not include interest on obligations secured by real property (e.g., mortgages) or secured by natural resource royalties.

*Article 16. Capital gains*

The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the source country. The exemption does not apply where an individual resident of one country is present in the source country, or maintains a fixed base in the source country, for 183 days or more during the taxable year. In addition, this provision does not apply to gains which are subject to the provisions relating to business profits (Article 8) or income from real property (Article 15).

*Article 17. Investment or holding companies*

The proposed treaty contains a provision which denies the benefits of the dividends, interest, royalties, and capital gains articles to a corporation which is entitled in its country of residence to special tax benefits resulting in a substantially lower tax on those types of income than the tax generally imposed on corporate profits by that country. This provision only applies if more than 25 percent of the capital of the corporation is owned by nonresidents of that country (in the case of a Korean corporation, U.S. citizens). A similar provision is contained in several recent U.S. tax treaties.

The purpose of this provision is to prevent residents of third countries from using a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits which the proposed treaty provides for dividends, interest, royalties, and capital gains derived from the other country. At the present time, neither Korea nor the United States grants to investment or holding companies the type of tax benefits with respect to dividends, interest, royalties, and capital gains which would make this provision of the proposed treaty applicable. Thus, the provision will have effect only if Korea or the United States should subsequently enact special tax measures granting preferential tax treatment to dividends, interest, royalties, and capital gains received by an investment or holding company.

*Article 18. Independent personal services*

Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (1) the person performing the personal service is present in, or maintains a fixed base in, the source country for 183 or more days during the taxable year and (2) unless the income exceeds $3,000 in the taxable year.

*Article 19. Dependent personal services*

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if four requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) the individual is an employee of a resident of or of a permanent establishment in his country of residence; (3) the compensation is not borne by a permanent establishment of the employer in the source country; and (4) the income for the taxable year does not exceed $3,000.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic is exempt from tax by the other country, provided that the employee is a member of the regular complement of the ship or aircraft.

*Article 20. Teachers*

The proposed treaty provides that a teacher or researcher who is a resident of one country will be exempt from tax in the other country on income from teaching or engaging in research in the host country if he is present in that country for a period not expected to exceed 2 years. The exemption only applies if the individual comes to the other country primarily for the purpose of teaching or engaging in research pursuant to an invitation of the host country (or political subdivision or local authority) or a recognized educational institution in the host country. It is not to apply with respect to income from research which is undertaken primarily for the private benefit of a specific person or persons.

If the teacher or researcher remains in the other country for a period exceeding 2 years, the exemption only applies to income earned dur-

ing the 2-year period. The exemption does not apply if the individual become a citizen of, or acquires immigrant status in, the host country.

*Article 21. Students and trainees*

Under the proposed treaty, residents of one country who become students in the other country will be exempt from tax in the host country on gifts from abroad used for maintenance or study and on any grant, allowance or award from a governmental or charitable organization. In addition, a $2,000 annual exemption from tax by the host country is provided for personal service income (such as income from a part-time job) derived from sources within the country in which the individual is studying. These exemptions together with the visiting teachers' exemption may not be utilized for a period of more than 5 years.

In addition to the exemption regarding students, the proposed treaty follows the approach of other recent U.S. tax treaties and provides a limited exemption for personal service income of residents of one country who are employees of, or under contract with, a resident of that country and who are temporarily present in the other country to study at an educational institution or to acquire technical, professional, or business experience. This exemption is available for a period of 12 consecutive months and is limited to $5,000. The proposed treaty also provides an exemption for income from personal services performed in connection with training research or study by residents of one country who are temporarily present in the other country for a period not exceeding one year as participants in Government-sponsored training research, or study programs. This exemption is limited to $10,000.

If an individual qualifies for the benefits of more than one of the provisions of this article and Article 23 (the visiting teachers exemption), the individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year. This provision does not apply to students or trainees who are citizens of, or who have acquired immigrant status in, the host country.

*Article 22. Governmental functions*

Under the proposed treaty, wages (including pensions or similar benefits) paid by one country to an individual for labor or personal services performed for that country in the discharge of governmental functions is exempt from tax by the other country. This exemption does not apply if the individual performing the services is a citizen of, or acquires immigrant status in, the country where the services are performed. The exemption only applies to compensation for services performed by the national governments of the United States or Korea.

*Article 23. Private pensions and annuities*

Under the proposed treaty, private pensions and other similar remuneration, alimony, and annuities derived from one country by residents of the other country are exempt from tax in the source country.

*Article 24. Social security payments*

Under the proposed treaty, social security payments and other public pensions paid by Korea to U.S. citizens and residents are to be exempt from U.S. tax. Such payments made by the United States to

Korean residents are to be exempt from Korean tax. The exemptions do not apply to payments described in Article 22 (Governmental functions).

*Article 25. Exemption from social security taxes*

The proposed treaty contains a special provision under which Korean residents working in Guam on a temporary nonimmigrant basis are to be exempt from social security taxes. The exemption is similar to the exemption contained in the Internal Revenue Code for residents of the Philippines working in Guam.

Specifically, the proposed treaty provides for an exemption from social security taxes with respect to wages paid for services performed in Guam by a resident of Korea while in Guam on a temporary basis as a nonimmigrant alien admitted to Guam pursuant to section 101 (a)(15)(H)(ii) of the United States Immigration and Nationality Act (8 U.S.C. 1101(a)(15)(H)(ii)). This exemption shall continue only so long as the similar exemption for residents of the Republic of the Philippines is provided by section 3121(b)(18) of the Internal Revenue Code.

*Article 26. Diplomatic and consular officials*

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements.

*Articles 27, 28, and 30. Administrative provisions*

The proposed tretaty contains various administrative provisions generally along the lines of the provisions contained in other U.S. tax treaties. In general, the proposed treaty provides—

(1) for consultation and negotiation between the two countries to resolve differences arising in the application of the proposed treaty and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of proposed treaty;

(2) for the exchange between the countries of information pertinent to carrying out the provisions of the proposed treaty and of the domestic laws of the countries concerning taxes covered by the proposed treaty; and

(3) that each country is to assist the other in collecting taxes imposed by the other country to the extent necessary to insure that the benefits provided by the proposed treaty are enjoyed only by persons entitled to those benefits.

*Article 29. Extension to territories*

The proposed treaty contains a provision similar to that found in some of our other income tax treaties by which the treaty may be extended to possessions or territories of either country which are not otherwise covered by the proposed treaty. This provision applies only to a possession or territory of a country if the country is responsible for the area's international relations and the area imposed taxes are substantially similar to those covered by the treaty. The treaty may be extended pursuant to this provision either in its entirety, or with any necessary modifications. The extension is to be effected by a written

notification given the other country and assented to in written communication, which notification and communication are then to be ratified by each of the two countries.

At any time after the entry into force of an extension under this provision is made, either country may terminate the extension on 6 months' prior notice through diplomatic channels.

*Article 31. Entry into force*

The proposed treaty will enter into force 30 days following the exchange of the instruments of ratification. It will become effective with respect to withholding Article 25 (Exemption from social security taxes) on the first day of the second month following the date on which the proposed treaty enters into force. With respect to all other taxes, it will become effective for taxable years beginning on or after January 1st of the year following the date on which the proposed treaty comes into force.

*Article 32. Termination*

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after 5 years from its entry into force by giving at least 6 month's prior notice through diplomatic channels. If terminated, the termination will be effective with respect to income of taxable years beginning (or, in the case of withholding taxes, payments made) on or after January 1 next following the expiration of the 6-month period.

## EXCHANGE OF NOTES

In notes exchanged at the time of the signing of the treaty, the United States noted that the Korean Government had stressed the need for provisions in the treaty which would constitute special incentives to promote the flow of United States capital and technology to Korea. While observing that the United States could not agree to such provisions, the United States did offer assurances that, when circumstances permit, the United States would be prepared to resume discussions with a view to incorporating provisions into the treaty, consistent with U.S. income tax policies regarding other developing countries, which will minimize the interference of the United States tax system with incentives offered by the Government of Korea.

In the same exchange of notes, the Korean Government confirmed that the definition of Korean tax for purposes of the proposed treaty includes the Korean Defense Tax assessed on the taxes referred to in that definition) i.e., the Korean income tax and corporation tax). The Defense Tax is levied as a surcharge on a number of Korean taxes, including the income tax and the corporation tax. The treaty applies only to those parts of the Defense Tax levied with respect to the income and corporation taxes.

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